Minutes from Federal Gas Rule Workshop
Denver, Colorado
April 23, 2003

A Federal Register Notice dated Thursday, April 10, 2003, announced that the Minerals Management Service (MMS) would hold four public workshops to discuss specific issues regarding the existing Federal gas royalty valuation regulations at 30 CFR Part 206 for natural gas produced from Federal leases.

Twenty-six participants attended the Denver, Colorado, workshop and represented 9 Companies, 1 Industry Group, 1 Law Firm, and 1 State.

<u>Opening Statements</u>

Debbie Gibbs Tschudy introduced the panel members and welcomed the participants. This is the 1st of 4 workshops to be held around the country.

The purpose of the current Federal gas rule is to ensure that the public receives a fair return on Federal resources. MMS believes the rule accomplishes this goal. However, we continually evaluate the effectiveness and efficiency of our rules. The existing rule is now 15 years old. With the changes in the natural gas market, our experience with the 2000 Indian gas rule, and 5 years of taking gas in kind, we are reevaluating the rule and asking for public input from our constituents.

We are seeking comment on the following issues:

- Should we simplify the current benchmark system for non-arm's-length sales? Should we allow lessees who sell production to an affiliate a 2-year option (similar to the oil rule) to base royalty value on either a published index for natural gas or their affiliate's arm's-length resale?
- Should we consider using NYMEX prices at Henry Hub in place of, or in addition to, published index prices?
- How should we adjust index prices for location differences?
- Are there other pipeline charges since MMS' 1998 amendment to the gas transportation allowance regulations for which MMS should provide clarification on whether they are allowable?
- Should MMS adjust the allowable rate of return for calculating non-arm's-length transportation allowances?
- Should MMS allow lessees to apply an index price to wellhead volumes to eliminate the requirement of tracing processed gas to remove liquids?
- Should MMS clarify valuation under joint operating agreements (JOA)?

<u>Affiliate Sales</u>

Question: Should MMS modify the gas rule to mirror the oil rule for non-arm's-length sales? Currently, value for non-arm's-length is based on the first applicable in a series of three benchmarks. The value under the applicable benchmark is compared to the gross proceeds received by the lessee to determine value (higher of). The recent oil rule allows lessees with non-arm's-length sales the option, for a two-year period, to base value on an index price or the affiliate's arm's-length gross proceeds.

Industry Comments:

- Many companies already track gross proceeds for their various landowners. Why not continue paying on gross proceeds? Using gross proceeds is fair and equitable. If an affiliate is wholly-owned, the lessee already knows gross proceeds.

- Tracing gross proceeds is burdensome. MMS should allow an option to pick either index or gross proceeds so companies can pick the option that works for them.
- A representative of the Royalty Task Force (membership of several industry organizations) commented that they:
  - -Applaud the effort to revise rules
  - -Are concerned that index will truly be an option
  - -Consider the 2 year requirement as fair
  - -If a company opts to pay on index, they would be paying on a higher value (or be willing to pay on higher value), to make the process simpler. This would reduce complexity to first point of sale, give ease of audit, and result in less controversy.
- This should not only be an option for non-arm's-length sales, but be open to all lessees (arm's-length sales, too).

Question: What are your comments on index prices?

Industry Comments:
- Our company would like to address index issue with specific comments at the Houston workshop.
- What is MMS' RIK experience? (MMS currently takes little or no gas in kind onshore). Basis adjustments between index points is controversial. You never know if the basis difference is related to transportation. Guessing wrong on basis is a big issue to companies, such as sudden basis issues in the Rocky Mountain region.
- People are interested in a simple, easy, no tracing-of-production option, but there is not always an index price where a company is selling gas. For instance, the Wyoming Opal, CIG index, etc.
- We don't want to pay a penalty for index not reflecting actual sales point, like concerns with the Indian rule. We suggest a task force be set up to study index. Index can be attractive if off a penny or two, but if index is off by 20 cents, it is not attractive.

Question: How valid have index prices been? Real sales have occurred at index prices. They reflect prices at which people actually sell gas. Many contracts are written to use index. What about areas with no index? Should MMS keep the benchmarks?

Industry Comments:
- For the Rocky Mountain region, use one of the published indices, plus or minus a premium.
- Use another nearby pipeline as a benchmark and adjust accordingly. But indexes can be volatile (within the month).
- Use adjustments negotiated between other buyers and sellers. But, are they are publicly available? No.

Question: What would non-arm's-length sellers use if there are no published indices?

Industry Comments:
- Lessees must explore the market by calling buyers or brokers to establish a price.
- Lessees would have to be careful in choosing index because of volatility.

Question: Should MMS offer an index option on an area-wide basis, rather than by company so company could chose between index and gross proceeds for specific areas? How would we define area?

Comments:
- One company stated that the option should be on an area-wide basis, not a company-wide basis. Perhaps COPAS has suggestions, it should be discussed among members.

- Publishers have a monopoly, subscriptions for small producers are cost prohibitive, and several publications might be necessary. Also, there may be manipulation of the prices.
- The lessor (MMS) should become a publisher.
- Does MMS' RIK onshore program have data? [It is not available.]
- Platt's is a compilation of buys and sells, and must be timely, must be every day. Platt's is addressing concerns of manipulation. Generally, the market works well, and MMS is not a good choice for publishing data.
- Some people in the workshop seem to advocate gross proceeds. MMS has gross proceeds information. Maybe, MMS should publish gross proceeds prices by area.
- There are not enough fixed price volumes being traded in some areas so Platt's doesn't publish indexes for those areas. This is a liquidity issue.

Question: How should MMS define area? Should areas be defined as a few broad areas, or should there be more numerous, specific areas.

Industry Comments:
- MMS should determine areas and ask for comments. MMS should ask: Where is your production? What index do you use? Do you trade to premium or discount? This will help define regions. MMS shouldn't exclude using in index in no-trade areas because tracing is so burdensome.
- MMS should use three main areas, Rocky Mountain, Gulf, and the Rest of the Country.
- Some comments favored a few broad areas, some favored more specific (numerous) areas.
- Can MMS choose not to allow companies to use index if a pipeline doesn't publish an index in an area? Some feel that there are other indexes to use as a valuation basis in this situation.
- Cheyenne is still traded on premium to CIG and no one trades on the Cheyenne Hub index that is now being published.

Question: What about disparity between index prices? Should MMS feel comfortable with two indexes in the same area that trade 10 cents apart? Is one better than another, is either one good?

Industry Comments:
- If Opal Plus or Cheyenne are 10 cents different, how do you evaluate either index? Are they truly representative of value compared to gross proceeds. Also, they may or may not represent actual physical trade.
- It is easier to believe a Mid-continent index than a Wyoming or Rocky Mountain index.

Question: The current rule specifies that value is the greater of gross proceeds or benchmark. Is it worthwhile to consider changes to gas rule like we did oil to eliminate this "higher of…" clause?

Industry Comments:
- MMS needs to remember that the operator will do the best they can because they have more to lose than the royalty owner. The royalty owner should trust that the operator is doing their best to get the best price. Small producers don't have firm transportation and are limited to transportation on one pipeline, they have no choice of indexes.
- Plus or minus in the price from index has to do with the skill of the marketer in negotiating price.

MMS Comment: MMS is not proposing to change the arm's-length regulations. We are requesting input on changing the non-arm's-length portion (benchmarks) of the gas rule.

Industry Comments:
- This is just for federal royalty, what about multiple pricing of various royalty owners?
- Companies have accounting systems to calculate each royalty owner's royalty as their leases demand.
- Even if you can pay MMS on index, you have to pay other royalty interests on gross proceeds. We see no reason to change the current regulations, especially with volatile indexes and discounts.
- It's not a given that other royalties are based on downstream first sale. When sales are pooled, sold, or traded, companies can't determine the gross proceeds, so this proposal should be an option. Gross proceeds requirements for some sales make audits too difficult, the first arm's-length resale can't be determined.
- We don't subscribe to statement that index is not reliable. Many contracts have a price provision where the contract price is the index price. The Wyoming market is a developing market, it will settle down.
- The Gulf is a spaghetti bowl of price and delivery points. New Mexico has only three pipelines. Can MMS RIK help prove validity of indices, could MMS be a publisher of index in Gulf?

MMS Comment: We don't replicate index, we use index. RIK contract prices are based on 2/3 of the first-of-the month bid prices and 1/3 of the Gas Daily swing price. We offer a number of index pricing points. We generally received index plus, less some amount to reflect the transportation component.

Industry Comments:
- The Gulf is more complex, companies have fights in the Gulf as to what is the right index, Henry Hub or Houston Ship Channel.
- We learned from 636 that FERC thinks we have open US grid, but index represents supply and demand in a particular region at a particular time. You can't correlate between regions or points, so it's not valid to use Mid-continent price with a differential to establish a price in other regions.

Use NYMEX in addition to, or instead of, Index (spot) Prices

Question: Should MMS use NYMEX instead of index, or in addition to index?

Comments:
- NYMEX doesn't work for places like Rocky Mountain. The Rockies do not track on a predictable basis to NYMEX.
- The basis differential from NYMEX to CIG is very volatile. There is no static or pre-determined basis differential for NYMEX in the Rockies.
- The NYMEX, less a location differential to the monthly index pricing point, ends up getting you back to the index price because there is no timing difference between NYMEX and index, like there is in oil. Then why use NYMEX?

MMS Comment: The intent of this proposal was to ask, "Should we move away from index (a controversial number) to NYMEX (which is not "manipulated")?

Industry Comments:
- Anything static (such as the basis differential) puts a producer at risk.
- What has MMS learned? How are we currently selling in the RIK arena?

MMS Comment: Currently, MMS is taking 400,000 MMBtu/day from 11 pipelines. The basis is 2/3 volume at the 1st of the month index and 1/3 volume at the daily swing gas in 7-, 5-, 12- month contracts. We are currently getting index plus. We negotiate our own transportation to get the best rate and assign the contract to a winning bidder. Index-based is the way the market is performing, we look at electronic bulletin boards to monitor. We are not allowed to do hedging. We have a finance office that determines credit worthiness of bidders. We offered some bids based on NYMEX, but those bids were heavily discounted for risk. The index bids beat the NYMEX bids.

Industry Comment:
- MMS should use index, it is market responsive, floating, and moving with (replicating) actual, physical sales.

MMS Comment: The chosen price method should reflect actual trades and be market responsive. It is not the intent to lock in a fixed basis, but the daily spot price on a specific day has some bearing (basis) on how is it rolled up monthly. If there is no disconnect on timing, then there is no advantage to use NYMEX. If we define index as "value" what happens with the daily price? It could be that companies sell one day for operational (swing production) or think the market will change. Should we define, or let the producer define, which price to use, daily or monthly? Most gas is sold on the monthly (bid week) price and not on the daily. The daily price can be favorable or unfavorable each day, so over time it evens out. The 1st of the month price always beats NYMEX because of the uncertainty, NYMEX is discounted. If we use NYMEX, there is a disparity to the Henry Hub.

State Comment:
- Has MMS done any comparison between gross proceeds and index? In 1997, index wasn't revenue neutral, and was a loss to the government. Does MMS plan to do a current cost analysis?

MMS Comment: We must do a cost analysis if we decide to change the rule. This workshop is being held to get input on other possible valuation methods.

State Comment:
- Certainly index will simplify the audit arena, but is just the starting point. States are concerned because they have generally seen more "index-plus" than "index-minus".

Question: Is gas tracing as problematic as it is for oil?

Industry Comment:
- Yes, tracing is very problematic.
- The index value for May production (the bid week price based on prices during the last week before May) is the value to use for May gas.
- Inside FERC is good index to use, it is a fair assessment. MMS may have problems proposing a specific index. In any new rule, MMS should state "use an acceptable" publication.

MMS Comment: Publications petition MMS to be deemed "acceptable". MMS would publish list of acceptable publications.

Industry Comment:
- Private leases are now including index clauses for determining value. There is greater interest in index-based royalty clauses. If such language comes into existence, any new rule should include caveats on what to do if an index ceases. This index-based clause concept is still moving to the forefront.

Question: If you are on a pipeline that has an index, should you have to use that pipeline index? For instance, a producer is connected to a pipe, but didn't use that pipe's index and chose another index. Free pooling (like in the RIK program) is MMS' first choice. If are 3-4 pipelines in an area, these could be used to calculate a range for all the pipelines. What is industry's experience in this situation? Do you calculate a range? Which index do you pick when you have a split stream? Is it the first index point, is it comfort level?

Industry Comments:
- If a company has a split stream and holds capacity on a pipe, it may not get highest price.
- Holding capacity is more to guarantee that you have market and can flow gas, not necessarily that you'll get higher price
- Producer may or may not use firm transportation, but may just pay to reserve space in the pipe.
- Accept index for where gas is produced regardless of producer ability to move gas out of that market.

Question: On split streams, do we take an average of the rates on each of the pipelines?

Industry Comments:
- A cautious "Yes" but MMS and industry would need to talk about the details
- In split stream situations, some gas stays local, some moves further down, a company may or may not hold firm transportation. The question is "what index to use"?
- Perhaps MMS should look at the Indian gas rule index calculation method (but without safety net, etc.)

<u>Adjust Index for Location Differences</u>

Question: How do we adjust index for location differences?

Industry Comments:
- The Indian rule is not consistent with industry practice (using actual location differentials), it uses a percent differential, but it is simple.
- Any number based on a percentage must bear a relationship to rationality.
- What other options are there? Ask in a proposed rule, gather facts.

Question: The differential is easy to calculate when we have an index to which gas physically flows and there is actual transportation. But, if gas doesn't physically flow to index point, how will we establish value?

Industry Comment:
- If production is in the Powder River Basin, OPAL is the closest index for gas flowing west. If gas is flowing east, gas won't flow to OPAL. The better market is east (Chicago).

State Comment:
- Is this really marketing? Does the Chicago price represent a wellhead/regional price?

Industry Comments:
- If gas is flowing to an index, it is more basis than transportation.
- A tariff is not an accurate measure of basis between market centers.
- If gas actually flows, use actual transportation costs.
- If there is no actual flow, have MMS publish a 6-month rate, using actual flow transactions reported to MMS by other producers.
- Publish prior 6-month data for producers to use as the next 6-month period.
- Use the 80-20 rule. How often do you not flow to the index? This is a bigger problem offshore because producer can go to so many places.
- The more market centers you go through before selling gas, the more problems as to what index to use.
- Have the option to use index only when you have actual transportation to allow you to get back to lease value.

- For offshore, companies would be willing to use RIK offshore calculated rates as transportation allowance.

MMS Comment: MMS sells at or near lease, and because we have large volumes, no one else can get the same rates.

Industry Comments:
- Ask pipelines and producers to help draw out areas or regions to establish index point. This will eliminate litigation and have no audit issues.
- Have MMS publish time delayed transportation rates based on the arm's-length transportation rates reported to MMS.
- Transportation is more static than index.
- We're not in favor of the Indian method, which caps transportation.
- Actual transportation, or an average, is better.

MMS Comment: Should it be an average by area or region? MMS gets information by lease. To calculate a weighted average, we wouldn't be able to distinguish between arm's-length or non-arm's-length transportation rates. Industry is suggesting that MMS calculate rates, but our system doesn't show where production is being sold, or whether the transportation is netted.

State Comments:
- Option to use an index should only be available if you flow to that index.
- If there is local index and you're not using it, it means the company has a sale. Use that sale to establish value.

Industry Comments:
- There is a difference between oil and gas, oil can be consumed internally, but gas has a final sale.
- Even if a company or its affiliate doesn't flow to index, we want MMS to come up with rates for differentials.

<u>Allowable Transportation Costs</u>

Question: Since the 1998 amendments to the gas rule to address FERC 636 costs, are there new costs you are uncertain about? Should we clarify the rules to address those costs?

Industry Comments:
- COPAS didn't have time to develop issues. This is an area where we do want clarification. There are terminology differences among companies. COPAS wants to identify what are downstream costs and what actually happens when these terms are used. COPAS will meet in May to clarify terminology.

MMS Comment: The court generally upheld our FERC rule except for firm demand charges paid for, but not used. We will clarify the rule to follow the court's ruling.

Industry Comments:
- What is the relationship between transportation costs if a company goes to index method? Can index payors deduct all potential costs?
- Does this allow companies to deduct firm demand if gas flows between lease and index point?
- Should transportation allowance be the same for choosing index, rather than an actual sale where government gets the benefit of uplift?
- People pay for firm because it guarantees they can move and sell their gas, not because it's a good deal.

- Most of the costs from the lease to the index pricing point do not involve FERC 636 costs because the pipeline from the lease to the index pricing point is not interstate and not subject to FERC.
- COPAS will provide input. For consistency, we need to define different terms.
- What costs would MMS incur if the gas were sold under RIK at the lease, or moved off-lease, vs. what the lessee incurs?
- MMS considers the intrahub transfer fee an administrative fee. This cost may be included in the lease sales price because the purchaser knows it will incur that charge.
- Park and loan fees are the same as scheduling fees. Storage and credit costs are costs to the producer.

MMS Comment: Currently, MMS takes the stance that physical movement is an allowable cost, sales and marketing costs are not allowable costs. Under federal and Indian leases, lessees have an implied covenant to market production at no cost to lessor. The 1998 regulations codified this concept.

Allowable Rate of Return for Calculating Non-Arm's-Length Transportation

Question: The existing rate of return is equal to 1 times the Standard and Poor's (S&P) BBB bond rate. Is this still appropriate?

Industry Comments:
- It is not so much a question of capital rate, but a question of what is the depreciable base when companies are buying and selling assets with transportation systems.
- The problem is whether to use acquisition costs or the original cost of the system for depreciation.
- Current rules use the S&P BBB bond rate, industry thinks this grossly underestimates capital costs.
- A better measure is the weighted average of cost of debt, plus pre-tax cost of equity.
- Why doesn't MMS allow companies to use acquisition cost? This should be the cost.
- We disagree with the term "rate of return". It should be the "cost of capital" and is more than the S&P BBB rate. It is understated and is not reflective of the cost of capital.
- This is not different than oil, but it should be higher then the current rate. Perhaps a pre-tax 1.8 or 1.85 percent of S&P BBB.

State Comment:
- If the government allows use of acquisition costs every time a system is sold, the previous lessee doesn't readjust its previous depreciation costs to correct any over-depreciation when it resold the facility. If the company gets to take new acquisition costs every time the facility is sold, should MMS just do a true rate of return?

Industry Comment:
- Generally, the facilities are fully depreciated, so the cost of capital should be applied to the cost they paid to acquire the system. If government uses the new price, then just take cost of capital as a "rate of return".

MMS Comment: Companies are allowed to depreciate an asset twice in oil rule, should we do the same for gas?

- Companies are unlikely to get adequate records when purchasing, but we do pay money for those assets and this is a cost, not a return. The deduction reflects real costs and is cost of capital.
- How do you assign value when you acquire a facility as part of acquiring a company? For tax purposes, you can step up in basis, you can elect to allocate back to the facility and get a step up in the pipeline, but seems like a lot of trouble.

- For those that acquire properties rather than companies, you may choose to allocate a capital cost to every asset.
- Industry feels it is good to have same method for oil and gas, for consistency, and the method should apply to processing also.

Apply Index to Wellhead Volume

Question: What do you think about the concept of using an index value at the wellhead for processed gas, i.e., not requiring lessees to report gas as processed gas? Should this be for both arm's-length and non-arm's-length? If arm's-length producers choose to use index, should this apply?

Industry Comment:
- Majors like this option, it reduces accounting problems.
- Wouldn't MMS lose money? Many think so, but it will vary based on liquid prices and also by area.
- Product values vary greatly, sometimes processing gives a greater value than the value we get for gas.
- The higher the price of natural gas, the less likely companies would process gas.
- Depends on efficiency, deductions are subject to fees.
- For POP contracts, processing costs are high and they want royalty owner to share in those costs
- This should be optional for 2 years.
- How would coalbed methane be affected?

MMS Comment: We view the costs of removing CO_2 from coalbed methane as treating not processing.

Industry Comments:
- Would a coalbed well be able to elect index, but not deduct costs for treating?
- Could this be used for coalbed methane?

MMS Comment: This is a moot point as coalbed is reported as unprocessed gas unless the CO_2 is sold. In that case, the lessee may claim a processing allowance against the value of the CO_2.

MMS Comment: Even for gas that is processed, under this proposal, you would pay as if the gas was unprocessed, based on the gas' MMBtu content. We haven't done a revenue study, which must be done before any rule becomes final. The benefit to using index applied to the wellhead is to simplify reporting and accounting.

Industry Comment:
- Do like we do today. If you use index, apply index to wellhead; if you do actual, apply actual to wellhead.

Clarify Value under JOA Contracts

Question: If a non-operator chooses not to take in kind, the operator sells the non-owner's volume under its own contract. When the operator's sale is non-arm's-length, should MMS presume that the non-operator's sale to the operator is non-arm's-length? We included this language in the preamble to the June 2000 Federal oil rule, should we include similar language in the gas rule or remain silent on this issue?

Industry Comments:
- One lawyer has recommended for the past 5 years that all clients negotiate a sales contract rather than market under the JOA.
- Other companies have executed sales agreements with non-operators.
- If a non-operator doesn't have a separate sale document, they are agreeing to let the operator market. This is an arm's-length sale.

MMS Comment: MMS received comments that some companies were concerned that non-arm's-length sales were used to value production of the non-operating party.

Industry Comment:
- Industry would like MMS to make the presumption that this is an arm's-length transaction.

MMS Comment: Written comments from industry should be submitted. Workshops minutes will be out on MMS' website.

End of workshop.